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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Index (UIL) Numbers: 461.00-00
162.00-00
263.00-00

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Control Number: TAM-111325-98

District Directors Office:

Taxpayer's Name:
Taxpayer's ID Number:
Taxpayer's Address:

Tax Year Ended:
Date of Conference:

LEGEND:

X =

Taxpayer =

Year 1 =

Year 2 =

Year 3 =

b =

ISSUES:

(1) When is a bank's liability for payment of its deposit insurance assessment relating to the first semiannual period of Year 2 fixed under the all events test of § 461 of the Internal Revenue Code?

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(2) If the bank's liability for payment of its deposit insurance assessment was fixed on December 31, Year 1, should the payments be currently deducted under §162 of the Code or capitalized under § 263?

CONCLUSIONS:

(1) The bank's liability for payment of its deposit insurance assessment relating to the first semiannual period of Year 2 was not fixed until January 1, Year 2, under the all events test of § 461 of the Code.

(2) Because of the answer reached in the first issue, we need not address this second issue.

FACTS:

X is the parent company of a number of bank holding companies, which own all the stock of fourteen banks in various states. X, the bank holding companies, and the fourteen banks are all members of an affiliated group of corporations that file consolidated Federal income tax returns. Each of the fourteen banks, hereinafter collectively referred to as Taxpayer, are insured depository institutions subject to the requirements of the Federal Deposit Insurance Act (FDIA), 12 U.S.C. § 1811 et seq. Taxpayer uses an accrual method of accounting and files its Federal income tax return on a calendar year basis.

The FDIA requires banks to insure customer deposits through the Bank Insurance Fund (BIF), which is administered by the Federal Deposit Insurance Corporation (FDIC). During the years at issue, Taxpayer was a member of the BIF.

In order to maintain its status as an insured bank, the FDIC regulations in effect during Year 1 required each bank to compute and "pay the amount of the semiannual assessment due for the current semiannual period, as shown on its certified statement for such period" 12 C.F.R. § 327.3. Payments for assessments covering the period January 1, Year 2 through June 30, Year 2, along with signed certified statements showing the actual computations, were due on or before January 31, Year 2. 12 C.F.R. §§ 327.2 and 327.13. The assessment amount was computed by multiplying a bank's "average assessment base" for the prior semiannual period by one-half the "annual assessment rate." 12 C.F.R. § 327.3. The annual assessment rate applicable for the first semiannual period of Year 2 for each bank was determined by the FDIC and communicated by December 1 of Year 1. The average assessment base for the first semiannual period of Year 2 was the average of the deposits shown on a bank's quarterly "reports of condition" dated September 30, Year 1 and December 31, Year 1.

A bank must give notice of its decision to terminate its insured status at least 90 days before the effective date of the termination. 12 U.S.C. § 1818(a)(1). If a bank does terminate its insured status and its deposit liabilities are assumed by another insured bank, the terminating bank must file a final certified statement and pay the normal assessment on its deposits, unless (1) the deposits are assumed by a newly insured bank, in which case the terminating bank is not required to file certified statements or pay any assessment for the deposits assumed after the semiannual period in which the assumption occurs, or (2) the assuming bank agrees to fulfill the terminating bank's obligation to file the certified statement and pay the assessment. 12 C.F.R. § 327.6(a). If a bank terminates its insured status and its deposit liabilities are not assumed by another insured bank, the terminating bank must continue to file certified statements and pay assessments "for the period its deposits are insured." The terminating institution is not required to file further certified statements or to pay further assessments after the bank has paid in full its deposit liabilities. 12 C.F.R. § 327.6(b).

New FDIC regulations were issued in December of Year 1 and were effective for the period beginning on July 1, Year 2. These new regulations generally changed the assessment payment dates and computation periods, and provided that an institution could elect to prepay on December 30, Year 2, its first quarterly payment for the semiannual period beginning January 1, Year 3. Taxpayer maintains that although not formally announced by the end of Year 1, the FDIC had established a procedure in which it would accept from a bank in December payment of its estimated assessment due for the first half of Year 2 prior to the filing of the certified statement. For institutions that paid prior to December 31, Year 1, the FDIC still required the institutions to complete and file the certified statement by January 31, Year 2, calculating the assessment in the normal fashion by subtracting the estimated paid assessment from the total assessment due as shown on the certified statement.

By letter dated December 1, Year 1, Taxpayer received notification from the FDIC of its assessment rate for the first semiannual period of Year 2. Using a copy of a certified statement, Taxpayer estimated the amount of its insurance assessment that would be due in January of Year 2. On December 29, Year 1, Taxpayer prepaid approximately $b million of deposit insurance to the FDIC for insurance covering the period January 1, Year 2 through June 30, Year 2, even though the payment and related certified statement were not due until January 31, Year 2. The signed certified statement, which showed the computation of the actual liability of the Taxpayer for the semiannual period, was not submitted until January of Year 2. The total amount paid in December was deducted from the total amount due. On its Year 1 Federal income tax return, Taxpayer deducted the $b million prepayment. For years prior to Year 1, Taxpayer paid the assessment in January of the semiannual period to which the assessment related and deducted the payment in that same year. For financial report

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purposes, the assessment payments were capitalized to an account titled "prepaid FDIC insurance" and amortized monthly to an "FDIC insurance expense" account.

LAW AND ANALYSIS:

Section 461(a) of the Code provides generally that the amount of any deduction or credit shall be accounted for in the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2)(i) of the Income Tax Regulations provides, in part, that under an accrual method of accounting, a liability (as defined in § 1.446-1(c)(1)(ii)(B)) is incurred and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that a deductible liability is generally taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of 1.263A-1T(a)(5)), and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Code sections and guidance published by the Secretary.

Section 461(h)(4) of the Code provides that the all events test is met if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy.

Section 461(h)(1) of the Code generally provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

Section 461(h)(2)(D) of the Code provides that in the case of a liability not described in §§ 461(h)(2)(A), (B), or (C), economic performance occurs at the time determined under regulations prescribed by the Secretary.

Section 1.461-4(g) of the regulations provides that in the case of liabilities described in paragraphs (g)(2) through (7) of this section, economic performance occurs when, and to the extent that, payment is made to the person to which the liability is owed.

Section 1.461-4(g)(5) of the regulations provides, in part, that if the liability of a taxpayer arises out of the provision to the taxpayer of insurance, economic performance occurs as payment is made to the person to which the liability is owed.

Section 1.461-4(k)(3) of the regulations generally provides that for payment liabilities for which payment is economic performance under paragraph (g) of this section, the requirement applies to liabilities that would be allowable as a deduction or otherwise incurred for taxable years beginning after December 31, 1991.

Thus, a liability is incurred and can be taken into account by taxpayers using an accrual method of accounting in the taxable year in which the following three requirements are met: (1) all events have occurred to establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability. § 1.461-1(a)(2). The first two requirements are referred to as the all events test. § 461(h)(4).

The agent questions whether the first requirement of the all events test was met on December 31, Year 1, or at some point in January of Year 2. The agent argues that the fact of liability was not fixed until January 31, Year 2, which was the due date for the payment and the signed certified statement. The agent believes that the last events fixing the fact of liability are submission of the signed certified statement and the provision of insurance coverage by the FDIC which does not begin until January 1 of Year 2. The agent is not questioning whether economic performance has occurred, or whether reasonable accuracy, the second requirement of the all events test, was met.

The Taxpayer basically argues that the fact of liability was fixed on December 31, Year 1, under FDIC law because it was in existence as an insured bank on that date, and it had deposits at the end of the final two quarters of Year 1. The Taxpayer argues that the only circumstances in which it would not have been liable, on December 31, Year 1, for the insurance assessment covering the first semiannual period for Year 2, would have been either if they had terminated by December 31, Year 1, and paid all their deposit liabilities, or had been merged into another insured institution. Because neither of those events occurred by December 31, Year 1, Taxpayer argues it was certain to be insured on January 1, Year 2, and thus, subject to the insurance assessment for the first six months of Year 2.

It is fundamental to the all events test that, although expenses may be deductible before they have become due and payable, liability must first be firmly established. United States v. General Dynamics Corp., 481 U.S. 239 (1987). Taxpayers may not deduct a liability that is contingent, or an estimate of anticipated expenses if the estimate is based on events that have not occurred by the close of the taxable year. Id. To satisfy the all events test, a liability must be final and definite in amount, fixed and absolute, and unconditional. See United States v. Hughes Properties, Inc., 476 U.S. 593 (1986). The issue in this case is what event fixes the Taxpayer's liability for the insurance assessment which covers the first semiannual period of Year 2.

In United States v. General Dynamics Corp., 481 U.S. 239 (1987), an accrual method taxpayer self-insured its liability for its employee medical care plan. The taxpayer established a reserve at the end of the year for its obligation to reimburse employees for medical care already received by the employees from third parties, but for which reimbursement claims had not yet been filed. The taxpayer deducted the amount of its estimated liability in this reserve account at the end of the tax year as an accrued expense.

The Supreme Court held that the last event necessary to fix liability was submission of a claim form by an employee, not receipt of medical care, and thus, the first prong of the all events test was not met because the last event necessary to fix that liability had not occurred by the end of that year. The Court noted that some individuals might not file a claim for reimbursement because of oversight, procrastination, confusion over the coverage provided, or fear of disclosure to the employer of the extent or nature of the services received. Thus, the Court reasoned that the filing of a claim was not a mere technicality, but a condition precedent to liability on the part of the taxpayer.

In United States v. Hughes Properties, Inc., 476 U.S. 593 (1986), the Supreme Court addressed whether the casino taxpayer could deduct an accrued liability for progressive jackpot amounts shown on payoff indicators on progressive slot machines at the end of its taxable year. Pursuant to state law, registered jackpot amounts as shown on the payoff indicators were recorded daily and could not be reduced until jackpot was paid. The Supreme Court held that the last event fixing the casino's liability was the last play of the slot machine before the end of the casino's tax year, because that event fixed the jackpot amount irrevocably under state law. Thus, the Court held that the all events test was met and a casino could accrue the amount of the jackpot guaranteed for payment on progressive slot machines even though the winning pull had not occurred and the jackpot had not been won by the end of the tax year.

The Court noted that the identity of the eventual winner of a jackpot was irrelevant to the existence of the liability, and the fact that there was an extremely remote and speculative possibility that the jackpot might never be won did not change the fact that as a matter of state law, the taxpayer had a fixed liability. "There is always a possibility, of course, that a casino may go out of business, or surrender or lose its

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license, or go into bankruptcy, with the result that the amounts shown on the jackpot indicators would never be won by playing patrons. But this potential nonpayment of an incurred liability exists for every business that uses an accrual method, and it does not prevent accrual." Id. at 606.

Rev. Rul. 80–230, 1980-2 C.B. 169, addresses the proper year in which a bank can accrue its liability for a semiannual assessment by the Comptroller of the Currency to pay the expenses of bank examinations. The issue is whether the bank, a taxpayer using an accrual method for reporting its income on a calendar year basis, can accrue on December 31, 1978, the semiannual assessment required to be paid to the Comptroller of the Currency for the first semiannual period beginning January 1, 1979. The assessment was based on the total assets of the bank as shown on the bank's December 31, 1978 report of condition, and was due on or before January 31, 1979. Applicable Comptroller of the Currency regulations provided that each bank "subject to the jurisdiction of the Comptroller of the Currency on the date of the second or fourth condition reports is subject to the full assessment for the next 6 month period without proration for any reason."

The semiannual assessment for the first semiannual period of 1979, based on the condition reports submitted for the fourth reporting period ending December 31, 1978, was sent to the Comptroller of the Currency with the required payment on January 30, 1979. Under these facts, the ruling holds that all the events that determine the fact of liability for the semiannual assessment occur as of January 1, 1979, and not as of December 31, 1978. The ruling notes that although the semiannual assessment is based on the December 31, 1978, report of condition, it is not payable until January 31, 1979, and is for the 6-month period beginning January 1, 1979.

We believe the facts of the present case are indistinguishable from the facts of Rev. Rul. 80-230. Similar to Rev. Rul. 80-230, the Taxpayer is attempting to accrue a liability for a payment which is for insurance coverage to be provided in a future taxable year with respect to deposits on hand in the future taxable year. The Taxpayer has no obligation under the FDIA or the FDIC regulations to pay the insurance assessment unless it is in existence on January 1, Year 2, and it has customer deposits on hand on that date that will be insured by the FDIC. The Taxpayer's obligation is not fixed and absolute, nor is it unconditional as of December 31 of Year 1. See 12 C.F.R. § 327.6(b), which limits a terminating bank's obligation to file certified statements and pay assessments only "for the period its deposits are insured." Thus, following the analysis of Rev. Rul. 80-230, we do not believe that all events necessary to fix the liability for the insurance assessment relating to the first semiannual period of Year 2 have occurred until January 1, Year 2.

The Taxpayer argues that the conclusion in Rev. Rul. 80-230 is erroneous, because the Comptroller of the Currency regulations provided that each bank "subject to the jurisdiction of the Comptroller of the Currency on the date of the second or fourth condition reports is subject to the full assessment for the next 6 month period without proration for any reason." According to the Taxpayer, the bank in Rev. Rul. 80-230 would be subject to the jurisdiction of the Comptroller of the Currency on December 31, 1978, unless the bank had converted to a state charter, ceased to do business, or merged with another institution. Thus, the Taxpayer argues that under applicable banking laws, the liability for the examination fee relating to the first semiannual period of 1979 was fixed on December 31, 1978 since none of these events occurred, and thus, the bank was subject to the jurisdiction of the Comptroller of the Currency on that date.

Despite the Taxpayer's argument, however, the conclusion reached in Rev. Rul. 80-230 is based on the fact that the event fixing the liability, the "required performance or other event," occurs as of January 1, 1979. The ruling indicates that the event fixing the liability for the assessment was the required performance of bank examinations covering the first semiannual period of 1979, and not the filing of the December 31, 1978, report of condition or the payment date of January 31, 1979. Thus, the analysis of Rev. Rul. 80-230 requires the conclusion that the Taxpayer's liability for insurance assessments covering the first semiannual period of Year 2 is not fixed until January 1, Year 2, as the last event fixing the liability–the existence of deposits owned by the Taxpayer requiring insurance coverage–does not occur until that time.

The Taxpayer also argues that because Rev. Rul. 80-230 was issued before enactment of the economic performance rules, the analysis of the ruling is no longer relevant.[1] In the ruling, payment was not made until January, 1979. The Taxpayer argues that because it made the payment in December of Year 1, its facts are distinguishable from Rev. Rul. 80-230. We do not believe application of the economic performance rules changes the all events analysis of Rev. Rul. 80-230. Even if the bank in that ruling had made payment of the semiannual assessment, the ruling's conclusion that all events was not met until January 1, 1979, would still stand because the payment was for future bank examinations covering the period beginning January 1,

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1 Generally, the economic performance test of § 461(h) of the Code is effective July 18, 1984, the date of enactment of the Deficit Reduction Act. Section 1.461-4(k)(3) of the regulations provides that the payment requirement for payment liabilities under § 1.461-4(g)(5) applies to liabilities that would otherwise be deductible or incurred for taxable years beginning after December 31, 1991.

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1979. The regulations at § 1.461-4(g)(5) make clear the fact that payment constitutes economic performance, in the presence of a payment liability. However, payment does not serve to fix the liability which must be established independently as a consequence of the all events test. Absent the existence of the liability, therefore, payment alone will not suffice to permit the taxpayer to accrue a deduction. Thus, Rev. Rul. 80-230 remains as a valid and pointed illustration of when the liability of the Taxpayer for deposit insurance becomes fixed.

Moreover, the Taxpayer argues that its liability is fixed pursuant to the FDIA and the FDIC regulations, and thus, its situation is similar to the casino's obligation in Hughes Properties. The Taxpayer argues that its liability is imposed under the FDIC regulations on the basis of facts which could not change after the end of the year, and the fact that it might cease operations before January 1 of Year 2 is irrelevant for purposes of the all events test.

We do not think the state law fixing liability in the Hughes Properties case is analogous to the FDIA or the FDIC regulations in this case. In Hughes Properties, the last pull of the slot machine at the end of the casino's taxable year established the exact amount, as shown on the payoff indicator, that the casino would have to pay at a future date. The last pull irrevocably fixed the casino's liability at the end of the tax year under state law, and only the identity of the actual winner was unknown at that time. In this case, the event which corresponds to the "last pull" in the Hughes Properties case is the provision of insurance coverage by the FDIC and the existence of deposit liability of the Taxpayer as of January 1, Year 2.

In Hughes Properties, the fact that the casino might go out of business in the next taxable year did not defeat the existence of a fixed liability. In this case, the fact that the Taxpayer might go out of business in the next taxable year could cause Taxpayer to not be liable for the first semiannual assessment of Year 2. For example, assume that a bank had not paid its first semiannual assessment yet, and on January 18, the bank terminates its insured status. The FDIC regulations provide that if a bank terminates its insured status and its deposit liabilities are assumed by another insured bank, the terminating bank does not have to file a final certified statement and pay the normal assessment on its deposits if the assuming bank agrees to fulfill the terminating bank's obligation to file the certified statement and pay the assessment. 12 C.F.R. § 327.6(a). Thus, in this situation, the terminating bank's liability for the first semiannual assessment of the year would be assumed by the assuming bank.

The FDIC is not necessarily concerned about which insured bank pays the assessment, as long as an insured bank pays the assessment if there are customer deposits to be insured during the first semiannual period. In essence, the liability to pay an assessment is fixed with respect to the deposits, but the deposits have to be the deposit liabilities of a particular bank on January 1 in order for that bank to be liable for the insurance assessment. Moreover, the FDIC regulations provide that if a bank terminates and its deposit liabilities are not assumed by another insured bank, there is no liability to pay for deposit insurance after the bank pays off all its depositors, or if it continues in business and none of the deposits are insured in the next period. 12 C.F.R. § 327.6(b). Thus, there are circumstances in which the FDIC regulations clearly relieve the terminating bank of its obligation to file a certified statement and pay the applicable assessment. There are circumstances in which the Taxpayer could contest its liability for a semiannual assessment, and the FDIC would have to establish their right to payment from the Taxpayer in that semiannual period. The Taxpayer argues that because it did not terminate by December 31 of Year 1, or give notice to the FDIC that it intended to terminate by that time, and because its deposits were not assumed by another insured bank, it was certain to be an insured bank on January 1 of Year 2. A taxpayer cannot deduct an estimate of an anticipated expense, however, no matter how statistically certain if it is based on events that have not occurred by the close of the taxable year. See United States v. General Dynamics Corp., 481 U.S. 239 (1987).

Thus, we believe the analysis of Rev. Rul. 80-230 requires the conclusion that the Taxpayer's liability for payment of its deposit insurance assessment relating to the first semiannual period of Year 2 is not fixed under the all events test until January 1, Year 2. The last event fixing liability is the existence of deposit liability of the Taxpayer on January 1 of Year 2, and the corresponding provision of insurance coverage by the FDIC beginning on January 1.

CAVEAT:

A copy of this technical advice memorandum is to be given to the Taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

- END -